Quickonomics

November 2, 2020

Yielding to fundamentals? More of a toss-up

India's gross market borrowing is estimated to hit Rs 12 lakh crore in fiscal 2021 - not only a whopping Rs 4.5 lakh crore higher than the previous fiscal's – but the sharpest increase in any given year.

If fiscal policy alone prevailed, that should push up the yield curve, including the yields on 10-year government securities (G-secs). But that hasn't happened yet. Credit largely goes to the Mint Road twist to yields.

The 10-year G-sec yield in India has not one, but three fundamental drivers – government bond supply, global crude prices and policy repo rate. An upward movement in any of these should, ceteris paribus, push yields up. And vice versa.

But recently, another influence has dominated - the Reserve Bank of India's (RBI's) 'unconventional measures.' These include extraordinary liquidity easing measures such as open market purchases[1] (OMO) and 'Operation Twist[2]' (OTs), and encouraging banks to buy G-secs.

We had argued in our March Quickonomics[3], "between the push of fiscal stress and the pull of lower crude prices and interest rates, expect the latter to sway yields".

And that has come to pass in the first half of the fiscal, with unconventional measures playing a large role too (see chart The Mint Road twist to tame the benchmark yield).

But as the second half approaches, will things be any different? Will it be back to fundamentals? Or will the unconventional measures continue to hold sway?

Our view

Though fundamental pressures from a large borrowing programme have accentuated, we believe that 10-year G-sec yields will average 6.2% by March 2021 versus our previous estimate of 6.5%, for the following reasons:

The RBI has looked through the current spurt in inflation and stated its commitment to stay accommodative and provide liquidity to the system through:

a. increased purchases of G-secs by conducting OMOs, OTs and introduction of OMOs for state G-secs, and;

b. increase in banks' limits for statutory liquidity ratio (SLR) securities under held-to-maturity (HTM) to ensure demand for G-secs remains strong

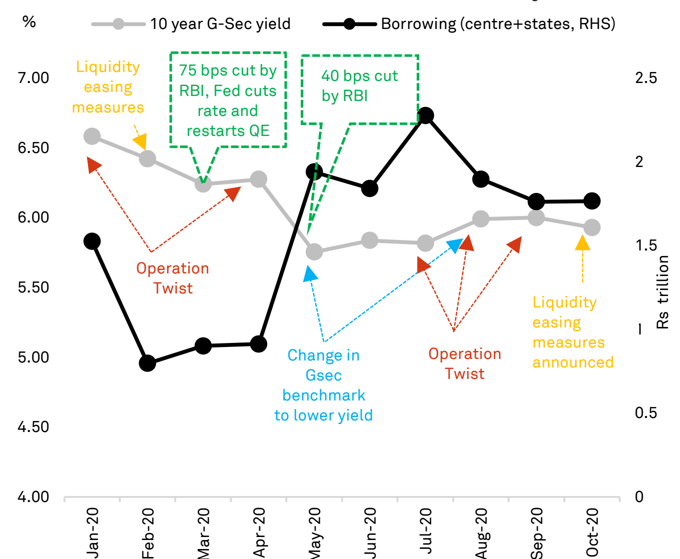
Yet, upside risks to yields persist and can materialise, in case of:

a. higher fiscal slippage leading to further increase in market borrowing

b. possible drying up of bank appetite for G-secs once domestic demand improves and credit offtake picks up

c. sustained inflationary pressures amid improving demand which will constrain the RBI's ability to maintain surplus liquidity

The Mint Road twist to tame the benchmark yield



Source: RBI, CRISIL

[1]The conventional way by which the RBI buys G-secs in the secondary market
[2]Under Operation Twists or 'special OMOs' under which the RBI simultaneously buys long-term and sell short-term G-secs. This reduces long-term yields and raises short-term yields, thereby flattening the yield curve and reducing term premium, without adding to systemic liquidity
[3]CRISIL Quickonomics: The yields poser, March 16, 2020

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Which fundamental factors are weighing on yields?

1. **Higher supply of government bonds:** That government borrowings will be higher this fiscal is known. Borrowings are expected at Rs 12 lakh crore compared with a budgeted estimate of Rs 7.8 lakh crore. Net borrowings could cross Rs 9 lakh crore compared with the budgeted amount of Rs 5.4 lakh crore. Both, revenue shortfall and pressure on additional spending (healthcare and stimulus) have forced the government to announce an increase in market borrowings.

   About 62% of this borrowing was completed in the first half, leaving the rest – Rs 4.3 lakh crore worth of dated government securities or G-secs – to be issued in the second. That's about 1.5 times more, on-year.

   Contrary to expectations, the government has so far refrained from increasing its planned borrowing for the second half of this fiscal – but that could change depending on the demands of the hour.

2. **Somewhat firmer crude prices and high inflation:** Crude prices were on a slide in the early months of the fiscal but have been firmer since July. CRISIL Research projects a marginal rise to $40-45 per barrel in the second half from an average of $37 per barrel in the first.

   Given the inflation targeting mandate, and with inflation continuing to remain above target for almost three quarters, the RBI refrained from cutting repo rates further.

   So the downside support to yields from repo rate cut is limited until inflation comes back to target.

What is capping the surge in yields?

1. **RBI's unconventional measures:** While inflationary pressures remained unexpectedly high, the RBI chose to 'look through the inflationary hump as transient' and continue with accommodative stance and unconventional measures, which have cooled down yields.

   a. **Bond buying:** Since March this year, besides the 115 basis points (bps) bps cut in repo rate and 155 bps cuts in reverse repo rates, the RBI has net-purchased Rs 2.4 lakh crore under outright open market operations until October. Moreover, it has conducted seven OTs, under which it purchased a total of Rs 67,130 crore of long-term G-secs and sold Rs 69,900 crore of short-term G-secs and treasury bills. These were pivotal in reducing yields in the first half of this fiscal.

   b. **Encouraging investments by banks in bonds:** RBI also nudged banks to invest more in G-secs. In September, it increased the limit of SLR securities under HTM to 22% from 19% of net demand and time liabilities (NDTL). G-secs are eligible SLR securities, which, if held to maturity, can help avoid losses on account of short-term interest rate fluctuations. These measures, coupled with weak credit offtake, has led to an increase in banks' investments in central and state G-secs to 31.1% of NDTL as on September-end, from 27.6% on March-end, much above the overall SLR limit of 18%.

   c. **Other technical adjustments:** The RBI has also capped yields by refusing bids in its auctions that demanded yields materially above 6%. This led to 62.8% of notified amount of issuances in August and 99.5% in September remaining unsold. The unsold bonds 'devolved' on primary dealers.

Going forward, the RBI is expected to continue supporting yields. In its October policy meeting, it reiterated that it "stands ready to conduct market operations as required through a variety of instruments" to assuage pressures arising from expanded supply of G-secs. It will continue conducting OMOs and OTs and also increase the size of these auctions to Rs 20,000 crore from Rs 10,000 crore seen in the first half of the fiscal. Enhanced ways and means advances limit have also been extended to the Centre and states till the end of this fiscal. This will reduce their need to borrow from the market for short-term liquidity requirements. Increased HTM limits for banks have been extended till fiscal-end as well.

Is there a limit to RBI's unconventional moves?

While the RBI is using a wider range of tools to ease yields, the easing itself could face limits from other factors. Specifically, its willingness to conduct OMOs will depend on to how much surplus systemic liquidity it is comfortable with.

When the RBI conducts outright open market purchases of G-secs, it adds to systemic liquidity. Liquidity has already been in surplus with domestic credit not picking up. This has further been boosted by surging foreign capital inflows amid global monetary easing. Given that the current account balance is also in surplus, the RBI's attempts to control excessive appreciation of the rupee have further added to domestic liquidity.

A study[4] by the Bank of England shows that persistence of surplus liquidity could lead to pressure on inflation, and weaker monetary policy transmission.

How can foreign inflows impact bond yields?

Swift and significant easing of monetary policy across the globe has helped revive foreign portfolio investor (FPI) inflows to emerging markets like India since May. However, most of the inflows have gone to the equity market. While the equity market has received $13.7 billion net inflows since May this fiscal, debt market has seen $3.3 billion outflows. Only 41% of the debt limit was utilised by FPIs until October, down from 75% in January 2020. Post that, the Covid-19 pandemic and fiscal stress seem to have kept foreign bond investors at bay, despite easy global conditions.

Growing fiscal stress in India could continue to dissuade FPIs from the G-sec market. India's growth-inflation mix has also fared worse than its peers.

What could trigger a rise in yields?

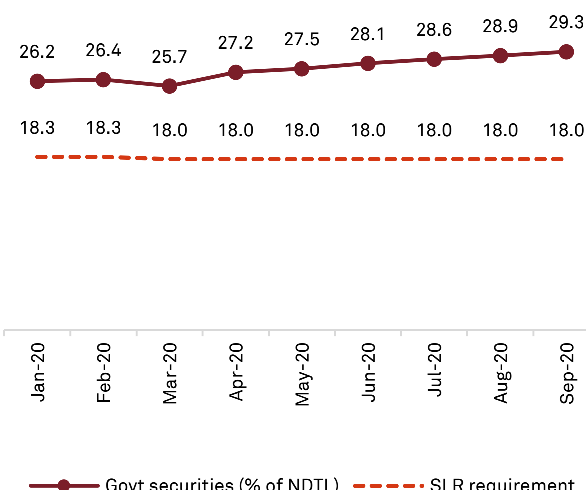
1. Unexpected rise in government borrowing

There is a fair chance that government borrowings could rise above the Rs 12 lakh crore target this fiscal, if there is further delay in containment of the pandemic in India and fiscal risks escalate. A further hit to revenue or higher burden of healthcare or stimulus spending can push the government to borrow more from the market.

2. Bank credit pickup

Fewer alternatives to deploy funds have led banks to invest much above the minimum SLR limit (of 18% of NDTL), in G-secs. Abundant liquidity in the system and bank deposit growth at ~10% suggest that banks are flush with funds. With credit growth weak (at ~5%), banks have either parked a large amount of their funds under the reverse repo window of the RBI (~4-5% of NDTL) or invested in government securities (~29.3% of NDTL). With returns on reverse repo coming down, investment in G-secs have got an additional push in recent months. But, G-sec investments could slow once economic recovery gains momentum and demand for credit improves.

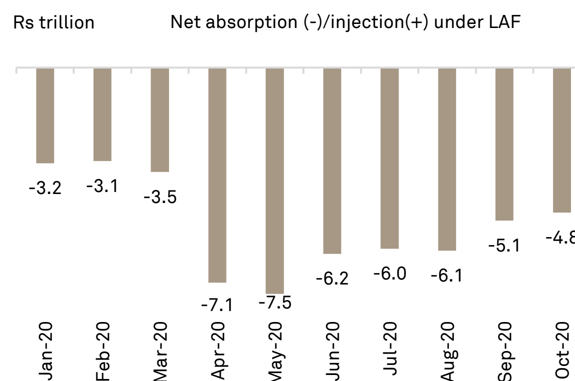
Banks' investment in govt securities



[4]Ganley, J. (2004). Surplus liquidity: Implications for central banks. Bank of England Lecture Series

3. Surplus liquidity and inflation risk

So far, most of the inflationary pressures are on account of high food inflation and a one-time hump in core inflation. These are not expected to persist going forward. A high base will help, besides, food prices are expected to soften as new supplies enter the market and weak demand should ensure that core inflation stays low. However, if inflationary pressures sustain amid improving demand conditions, it could constrain the RBI's ability to maintain surplus liquidity.



Source: RBI, CEIC, CRISIL

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